GOVERNMENT FINANCE

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Summary

The article examines the financial role of government, involving the raising of revenue and the spending of money to finance public services and projects, mainly through the budgetary process. In the second section, the article identifies the major structural components of public expenditure. It analyzes the reasons for such expenditure, including the necessity to provide collective and partially collective goods and merit goods. It also considers the different types of expenditure classification and the main items for which government provides funding. In the third section, the sources of government finance are considered, especially taxation. The principles that shape taxation are discussed, as well as the various types of taxation and their economic and social impact. The section further identifies non-tax sources of revenue, and examines the borrowing of money by governments and the reasons for it. The fourth section analyzes the factors that influence the size of government expenditure and revenue raising. In this section, the consequences of fiscal deficits are also evaluated, which focuses in particular upon the possible inflationary impact of large deficits. In the fifth section, the budgetary process is discussed, examining how the budget is prepared, who is involved in the preparation, and the role of the legislature in scrutinizing and authorizing the budget. Also considered are how the budget is implemented, and the practices followed to ensure efficient management of government expenditure and effective delivery of public services.

Throughout, the article identifies the recent trends and reforms in the different aspects of government finance. These include the reduction or elimination of fiscal deficits, restraints in public expenditure, reduction in the burden of taxation, especially income taxes, multi-year budget preparation and the application of business practices to

government administration such as target-setting, performance measurement, and accrual accounting.

1. Introduction

Government finance involving the raising of revenue and expenditure to finance public services and projects, mainly through the budgetary process, has become an increasingly important aspect of the role of government in the twentieth century. This has been due to several factors: financial exigencies of two world wars, the growth of public services including welfare provision, the adoption by governments of Keynesian principles of demand management, the creation of state owned commercial enterprises, and the role assumed by governments in developing countries to spearhead development. The resultant expansion of the fiscal function of government in the three areas of public expenditure, revenue raising, and borrowing, has, however, over the last two decades come under critical scrutiny that has focused upon the need for discipline, restraint, and accountability. This has been reflected in policies pursued in many countries in recent years to reduce government spending, minimize or eliminate fiscal deficits, create more efficient use of government resources, and deliver better public services. In conjunction with these policies have been other measures to reduce government control and ownership of significant areas of the national economy.

In the light of these trends, the article will first analyze the reasons for, and the classification and composition of, government spending. It will also discuss the sources of government finance, mainly taxation and borrowing, and the principles that shape taxation as the main source of government revenue. The article will then consider what determines the overall quantity of spending and revenue raising, and will assess the consequences of fiscal deficits. The article will further examine the budgetary process by which decisions on government spending and revenue acquisition are made and implemented, and the management of the government's financial resources is undertaken. In conclusion, the recent trends and reforms in the different aspects of fiscal policy will be highlighted.

2. Government Expenditure

2.1. Reasons for Government Expenditure

Government or public expenditure comprises current and capital expenditure on goods and services provided by the state and financed by revenue and loans credited to the public purse. Added to this may be transfer payments to individuals, which may be significant where there exists an extensive welfare system. Public expenditure may also include government loans given to government or non-government agencies for development projects, subventions to loss making public enterprises and nationalized industries, block grants to local government, and payments made by the government to service its own debt. In other words, the total of all outlays incurred by the government. It is debatable whether or not spending by local government, independent of central government and which is financed by local government taxes, should also be included as part of government expenditure.

A major reason for public spending is the provision of pure collective goods. These are goods, which cannot be appropriated by any one person or organization. Once they are made available, they are made available to all. Excluding others is not possible or is prohibitively costly. In addition, such goods are non-rival in so far as one person can increase his consumption without any decrease in consumption by others. As a result of non-exclusion, the market cannot provide these goods, which then, given their importance to individuals, must be provided by the state (see *Economic Development and Government*). Examples are national defense, policing, programs to improve the environment (of increasing priority), and infrastructure projects such as flood control schemes, drainage and road building.

A further reason for public spending is the provision of partial collective goods. These are goods, which may be appropriated by individuals or organizations to the exclusion of others unlike pure collective goods, but their use or consumption by those persons or organizations produces knock on benefits to many others and even the entire society. These additional benefits may be considered as positive externalities. The problem here is that under market conditions the demand for these goods will be determined only by their value to the direct consumers and not by their value to the other beneficiaries or to the public at large. Consequently, supply will not be sufficient to meet the needs of the other beneficiaries or the society as a whole. If these benefits are important, then the state must intervene to ensure, either by direct provision or by means of subsidy, that supply is sufficient. An example is education, which benefits those being educated and indirectly society as a whole by creating an educated workforce that is essential to economic prosperity. A further example are government services to improve agriculture in developing countries, which benefits not only the farmers, but also the public at large by ensuring an adequate supply of food, and perhaps increased foreign earnings through exports of agricultural produce.

An additional element in public expenditure, likewise in response to market failure, is the provision of merit goods. These are goods to which individuals are entitled by right, but which they may be denied if the market allocates them. The most important of these are services, which ensure that all citizens can enjoy a minimum standard of living and equality of opportunity. They include state-aided education, subsidized low-cost housing, free or subsidized health services, and various welfare payments and schemes for the needy and vulnerable sections of the community, such as the aged, disabled, those who are unemployed, and children. Merit goods are, therefore, central to the equitable distribution of wealth and opportunities in society.

Government also intervenes to provide goods which can only be efficiently supplied by one facility leading to natural monopoly, the most notable examples of which are utilities, such as electricity, gas and water. Usually the government allows public utilities operational autonomy, but may retain control over pricing and investment policy in the public interest. In recent years, certain governments have privatized utilities by introducing an element of competition. Private companies may bid for the license to run a public utility subject to price regulation by government, as has happened in the United Kingdom. Any surpluses or profits made by utilities whether owned by the state or privatized are not normally channeled into the public purse, but remain at the disposal of the utilities to be used for whatever purpose they consider appropriate.

It may be noted that certain goods provided by the state are a mixture of the different types of public goods. For example, state aided education and public health services are both partially collective goods and merit goods. Roads are a collective good, the upkeep of which can best be undertaken through a natural monopoly of a state agency.

2.2. Classification of Government Expenditure

There are different ways to classify government expenditure, and most countries use a combination of classification systems. The main one is the categorization of expenditure according to general function or purpose, e.g. defense, health care, and education. A related system of classification is based on organization, indicating how much is appropriated to each ministry and government-funded agency. With the development of program budgeting in the 1960s and 1970s, programs (sets of inter-linked activities pursuing the same objectives) have become a further basis of classification, e.g. environmental health, or land transport. Some programs are set within clear organizational boundaries and to that extent a program classification dovetails with the organizational classification. Other programs, however, may be undertaken by more than one organizational entity. Classification by program has assumed greater importance in the last decade or so in certain countries, as a result of target setting and performance measurement within programs, with contractual obligations by program managers to meet the targets set, as will be discussed below.

At the same time, expenditure may be categorized according to an economic or object system of classification, indicating the objects of expenditure such as wages and salaries, supplies and services, loans, grants and other transfers, and interest payments on government borrowing. Whilst the other systems of classification mentioned above tend to focus upon outputs, the economic classification system to a much greater degree identifies inputs or resources, such as physical assets, supplies and services.

In all these classification systems, sub-classes of expenditure are identified. Under organization classification, ministries may be divided into departments. Under program-based classification, programs may be sub-divided into sub-programs or activities. For example, environmental health as a program may be subdivided into a number of activities, such as food control, vector control, and refuse disposal. Economic or object classification may be similarly broken down. One may start with an object class (e.g. supplies and services), sub-divided into an object group (supplies and materials), which in turn is further sub-divided in objects (office supplies).

Each of these forms of classification serves particular purposes. Function classification is necessary to enable governments to prioritize their policies, and thus facilitates policy making. On the other hand, economic classification is an important tool of financial management in helping to maintain control over expenditure and achieve a more efficient use of resources. With organizational classification, lines of accountability can be established. Program classification is useful in all three respects: it enables funds to be apportioned according to the priorities set, provides a measure of how efficiently and effectively resources are being used, and makes program managers accountable for their results. This is especially so when program budgeting incorporates target setting, performance measurement and contractual commitments.

2.3. Composition of Government Expenditure Classified by Function

Governments vary in the distribution of their expenditure between and within these four categories. Table 1 indicates that the main items of expenditure are defense, general public services (especially policing), education, health care, housing, social security, and infrastructure development (although the figures given in the table are calculated from incomplete IMF returns). The amount spent on each of the above reflects policy priorities of governments, the influence of vested interests, and geo-political factors. In the U.S.A. the biggest item of expenditure is welfare, which accounts for 29 per cent of total expenditure. The other main items are health care accounting for 20 per cent and defense, which comprises 16 per cent of total public spending. In other advanced industrialized states spending on welfare is even higher averaging over 36 per cent. In developing and newly industrialized states, major items in government spending are education and infrastructure development, accounting for higher proportions of total spending than in industrialized states. In some of these countries, defense spending is also a high priority, particularly in the Middle East (20 per cent of total expenditure) and in Asia (14 per cent). However, health care and welfare as a percentage of total government expenditure comprise much lower proportions of total spending than in industrialized states.

	Defense	**Education**	**Health**	**Welfare**	**Infrastructure**
U.S.A.	16	2	20	29	4
Industrialized States (others)	5	8	10	36	6
Eastern Europe	6	7	9	30	7
Latin America	6	15	10	19	9
Asia	14	15	5	5	14
Middle East	20	13	8	11	7
Africa	9	16	6	6	8

Source: International Monetary Fund (1998). *Government Finance Statistics Yearbook, 1998,* vol. xxii, Washington D.C.: International Monetary Fund, pp. 4-7.

Table 1. Expenditure by function as percentages of total government expenditure.

3. Financing Government Expenditure

3.1. Taxation

3.1.1. Principles of Taxation

The bulk of public spending is financed through government revenues credited to the public purse and itemized each year in the budget. The main source of government revenue is of course taxation. The system of taxation in any country will be shaped in the main by two underlying principles: optimality and equity. The differences in the importance attached to these principles, and how they are interpreted from one country to another has given rise to a wide variety of tax systems.

The principle of optimality emphasizes the need for any system of taxation to prevent as much as possible, productive output and consumer satisfaction falling short of the optimal level that can be achieved given the actual and potential economic resources available. In many cases, this requires the system of taxation to be neutral in its impact on economic choices, so avoiding unnecessary and detrimental distortions in economic behavior. Where such distortions occur, it leads to a net loss of economic welfare or excess burden. Optimality is eroded if taxes lead to a reduction in the availability of productive resources, and/or prevent those resources being allocated in accordance with consumer demand, so preventing a sufficient amount of them being channeled into the most profitable forms of production. It is also eroded if resources once allocated cannot, as result of taxation, be used in the most efficient way.

Related to this is the goal of minimizing negative externalities, where production or consumption may harm others or society in general, and the costs of such are not met by those responsible through the market price. An example is environmental pollution from certain types of industrial enterprise. Taxes are imposed with the intention of discouraging such types of production or consumption, and compelling the producers or consumers concerned to meet the full cost of the negative externality.

The other principle at the heart of taxation is equity, which involves treating equals equally and unequals unequally. In determining who falls into the category of equals or unequals, one may refer to the ability to pay taxes, or alternatively to the benefits derived from taxes (the benefit principle). The more commonly applied of the two is the ability to pay, as determined by the means and resources at the disposal of the taxpayer to pay taxes. This may be measured by three different criteria: income, consumption, and wealth (including the transfer of wealth). Certain taxes based on this principle may serve as a means of reducing inequality by redistributing wealth and income. With reference to the other criterion of equity, the benefit principle, it may be argued that the tax system should take into account how much a taxpayer benefits from a public service in determining his/her tax liability. The benefit principle is reflected in charges and fees levied on specific public services at point of delivery and in certain types of consumption taxation, as discussed below.

3.1.2. Taxes on Income

Apportioning due weight to each of the above principles is not easy in any country, and depends upon prevailing social values, economic circumstances, and political goals. This has given rise to major variations in the system of taxation from one country to another. In most countries, a significant, if not the major source of tax revenue, is income, i.e. the net addition to wealth. There are various types of income tax, all of which are fashioned out of the ability to pay principle. The main one is the progressive personal income tax. This involves segmenting income into tax bands with each band taxed at a higher rate than the one below. This means that higher income earners will forfeit a greater proportion of their income in tax than lower income earners. Variations exist from country to country in how progressive the income tax structure is. This depends upon the level of income when the income earner becomes liable for tax, the width of the tax bands, the increases of the marginal rate from one tax band to the next, and the type and extent of the allowances, which are granted to reduce taxable income. Of particular importance is the lowest and highest marginal rates. Of equal salience are allowances, which take into account the needs and circumstances of the taxpayer, such as tax relief for children, care for elderly dependants, and borrowing incurred to buy a home. In some countries, the income tax structure is steeply progressive, with the higher earners paying a much greater proportion of their income as tax than the lower income earners. In other countries, the income tax structure is only mildly progressive.

In many countries with welfare systems requiring high levels of public expenditure, a special social security or national insurance tax may be levied on income. This is necessary to provide revenue for financing welfare and health care provision, such as pensions, unemployment benefit, child benefit, and health care costs. Social security levies, like normal personal income taxes, are often progressive in structure, and so further contribute to the distributive purpose of welfarism.

The other type of income tax is that levied on corporations in relation to their net earnings or profits. Whilst its primary rationale is based on the ability to pay principle, it may be further justified by the benefit principle since companies benefit from public services such as roads for transporting goods. In most countries, the majority of corporate taxpayers are small corporations, but the preponderance of the revenue is derived from the minority of large corporations. The precise structure of corporate tax, as with other systems of taxation, varies a good deal. Different criteria are used in calculating taxable profit. Corporations may claim exemption for depreciation of capital equipment and for depletion if the company is involved in resource extraction, and for losses incurred in the previous year(s). Certain types of outlays such as expenditure on research and development, "clean" technology to minimize pollution and charitable contributions may also be offset against the company's profits. The key question is how the portion of profits distributed to shareholders is taxed, given that dividends will be subject as well to personal income tax. To avoid double taxation, in some cases, only retained profits are taxed. In other cases, the corporation pays tax on all its profits. The shareholder then pays personal income tax on his share of that profit (including retained profit) but, to avoid double taxation, reduces the liability by the amount already paid by the company for that share. In some countries, corporate taxes are low or non-existent, and in others they are high, siphoning off as much as 40 per cent of corporate profit.

Although both personal and corporate income taxes may be equitable in promoting income distribution, their impact on economic behavior is far from neutral and thus may interfere with the optimal supply and allocation of economic resources. Perhaps the most serious distortion of progressive income tax is the disincentive to augment income. Where the tax is steeply progressive, taxpayers may be less inclined to save or invest their earnings or to make sacrifices to augment their income (such as by acquiring extra skills through training and by working longer hours). Steeply progressive taxes may, in particular, discourage individuals from taking risks (e.g. setting up a small business) since they are considered not worth taking in view of the amount of potential income to be earned that will be forfeited in tax. The impact of corporate taxation is more difficult to determine, and will depend upon the rates of tax and the exemptions allowed. It is generally true that the tax adversely affects corporate savings and investment, since less profit is available for these purposes. This effect will be compounded if companies do not pay taxes on distributed profits, so providing an incentive to retain a smaller share of their profits which can be used for investment. If, however, companies are required to pay taxes on all profits, their response may be in some cases to retain a greater share of their profits in order to compensate for their tax outlays, which has a less detrimental effect upon savings and investments. This would, however, shift the burden onto the shareholders, as fewer dividends will be distributed, so reducing personal savings. On balance, income taxes are deemed to have negative economic effects by reducing capital formation and discouraging entrepreneurship, although promoting a more equal distribution of income.

In recent years, in some industrial countries, an example being the United Kingdom, income taxes have been reduced and the tax structures have become, if anything, less progressive. This has been made possible by reduced revenue needs arising from restraints in public spending, and increased revenue flows in a period of economic growth. It is also considered desirable to allow low and middle-income earners whose incomes have risen during a period of economic growth to be free from excessively high marginal rates. In addition, lessening tax rates in the middle and higher income bands is also popular amongst middle-income earners and can be a vote winner for the governing party.

As shown in Table 2, in the United States the large preponderance of revenue is derived from income tax, including social security contributions. In other developed countries the proportion is less, although more than 50 per cent if social security levies are included. Amongst Eastern European countries, 40 per cent of revenue is derived from these sources, the bulk of which comprises social security levies—possibly a legacy of the welfare systems that existed under previous communist regimes. In Latin America, Asia, and Africa, the proportions vary between 25 and 30 per cent, with only a small fraction derived from social security taxes. The lowest proportion of revenue drawn from income and social security is found amongst Middle Eastern countries.

3.1.3. Taxes on Consumption

The second type of taxation is that levied on consumption, referred to as indirect taxation. This entails taxing goods and services through the process of transfer or distribution. Such taxation reflects an alternative measure of ability to pay, since consumption may be taken as reflecting the financial means or resources at the disposal of individuals and organizations.

The main type of consumption tax is that levied on the selling of goods and services. There are two approaches to the taxation of sales: imposing the tax at one stage in the distribution process or alternatively doing so at each stage. Single stage sales taxes may be imposed at the point of manufacture, at the wholesale stage, or when the goods are finally sold in the retail outlets. Most commonly, the tax is levied at the retail stage, based on a proportional rate, to take advantage of the maximum value goods have achieved in the distributive chain. This, together with the wide range of goods and services to which the tax is applied, ensures that the proportional rate remains quite

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Biographical Sketch

Dr. David S. Jones is an Associate Professor in the Department of Political Science, National University of Singapore. Before coming to Singapore, he had been a professional officer in the Northern Ireland Civil Service in the UK, and later an officer designated by the Overseas Development Administration in the U.K., lecturing at the University College of Botswana, Southern Africa. His research and teaching specialisms are public management, government budgeting, electoral analysis, and Irish politics, in which he has an extensive range of publications. He is the author of *Graziers, Land Reform and Political Conflict in Ireland* (Washington: Catholic University of America, Press, 1995).